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BIG deal

Tax Court rejects dollar-for-dollar discount, embraces NAV method

The debate over the appropriate valuation discount for the built-in gain (BIG) tax continues, with the U.S. Tax Court sticking to its guns in a recent case by opposing a dollar-for-dollar discount. This decision came despite the fact that two federal courts of appeals have ruled otherwise. In *Estate of Richmond*, the Tax Court also explained that the net asset value (NAV) method is more appropriate than an income capitalization approach when valuing a marketable securities holding company.

INTEREST AT ISSUE

The decedent's estate held a 23.5% interest in an investment holding company, whose strategy was to maximize dividends, minimize taxes and preserve capital. The company's underlying publicly traded securities were priced at about \$52 million at the date of death, but 87.5% of the value was unrealized appreciation. If all of the securities were sold on the date of death, the BIG tax would come to \$18.1 million.

> *Courts overwhelmingly use the NAV method for holding company assets that are marketable securities.*

The estate's tax return reported the value of the decedent's interest at \$3.1 million based on an unsigned draft valuation report from an accountant. The IRS issued a notice of deficiency that adjusted the interest in the holding company to a value of about \$9.2 million — boosting the estate tax liability by almost \$3 million.

THE EXPERTS' POSITIONS

When the case went to court, the estate hired a valuation expert who used the capitalized dividend method to reach a \$5 million value. He corroborated his figure using the NAV method, which produced a value of \$4.7 million, including a dollar-for-dollar \$18.1 million discount for the unrealized BIG tax.

The IRS expert used only the NAV method and calculated a value of \$7.3 million. This value included a 15% discount for BIG tax liability.

FAVORING NAV

The Tax Court began by choosing the NAV method for valuing the holding company. According to the court, the income capitalization method assumes that, if an asset produces a predictable income stream, its market value can be determined by calculating the present value of that future income stream. It also assumes that a company has a history of reliably paying out dividends.

But, by definition, the income capitalization method relies entirely on estimates about the future — for example, forecasts about the general economy, company performance or dividend payouts. So even small variations in those estimates can have substantial effects on value.

Dividend capitalization, the court said, may be entirely appropriate when a company's assets are difficult to value. That wasn't the case here, though, where the assets were publicly traded securities with actual market prices. And, as the Tax Court noted, courts overwhelmingly use the NAV method for holding company assets that are marketable securities.

PLAINLY WRONG

The Tax Court acknowledged that the NAV approach has its own issues, including determining an appropriate BIG discount. Although the Fifth and Eleventh Circuit Courts of Appeals have accepted dollar-for-dollar reductions, the Second and Sixth Circuits have declined to do so.

The *Richmond* court found the 100% approach "plainly wrong" for this type of case, where a willing buyer and seller "clearly" wouldn't agree to a discount that treats a potential liability susceptible to indefinite postponement as if it were an accrued liability due immediately. The court opted for a discount in the amount of the present value of the future capital gains taxes, or $7.8 million.

ESTATE PLANNING OPPORTUNITY

The Tax Court's unequivocal rejection of a 100% BIG tax discount in jurisdictions other than the Fifth and Eleventh Circuits may provide some planning opportunities for your clients. An estate that's probated in either of those circuits, or that has an executor living in one, may be able to garner a more generous BIG discount than the Tax Court would otherwise allow.

UNQUALIFIED APPRAISAL LEADS TO UNDERPAYMENT PENALTY

The estate in *Estate of Richmond* (see main article) was assessed a 20% penalty on its underpayment of tax attributable to a "substantial" estate tax valuation understatement. Its use of an unqualified appraiser was, at least in part, to blame.

An underpayment is "substantial" if the value of property required to be reported on an estate tax return is reported at 65% or less of its correct value. The court found the correct value of the decedent's interest to be about $6.5 million. But the estate reported a $3.1 million value, well below the threshold.

Penalties don't apply when an underpayment was made in good faith and due to reasonable cause. However, the Tax Court found this exception didn't apply in *Richmond*. It faulted the estate for basing its reported figure on an unsigned draft valuation report provided by an accountant who wasn't a certified appraiser. Moreover, the estate never explained the defects in the original valuation that led to its being abandoned by the estate in favor of a higher value at trial.

Stopping business identity theft

Individual identity theft has gotten a lot of press in recent years, but what about the theft of a business's identity? For many of your clients, their identity and their company's identity are virtually the same, and a crook's hijacking of the latter can have crippling effects on their personal and professional lives. Make sure clients know the risk of this dangerous type of fraud, as well as how to help prevent it.

KNOW THE RISKS

Business identity theft occurs when fraudsters assume the identity of a company's owner, officers or employees to obtain cash, credit or loans. For example, with an owner's Social Security number and other personal information, a thief could apply for — and quickly exhaust — a line of credit. The victimized company is then stuck with the debt and may even lose assets that were fraudulently pledged to secure the loan.

Potential consequences of business identity theft include:

- The inability to pay employees, tax obligations or bills,
- Personal liability,
- Negative credit reporting,
- Loss of personal income, and
- Litigation to defend ownership of intellectual property, such as trademarks, copyrights and patents.

In a severe case, losses associated with identity theft could lead to a business's failure.

PREVENTION IS BEST

Although thieves are constantly thinking up new ways to steal identities, business owners can take steps to reduce the odds of being victimized. For example, they should closely monitor their business accounts and, in certain industries (such as retail), reconcile accounts on a daily basis. They also should review and reconcile bank and credit card statements — as soon as they arrive — with an eye toward suspicious purchases or transactions. Many identity thieves will initially make a few small purchases on a hijacked account and, if the business doesn't appear to notice them, proceed to larger transactions.

Unauthorized accounts and debt will eventually show up on a company's credit report. Businesses are advised to routinely order reports from the three main credit agencies and review them for inaccurate and suspicious activity.

Business owners also should keep their company and personal finances separate. Personal credit cards, accounts and lines of credit shouldn't be used for business-related transactions. Note that most banks and credit card issuers exclude business-related transactions made with a personal card from their "100% fraud protection" programs. This means that owners could be personally responsible for losses that result from fraudulent business charges and withdrawals.

Finally, owners should periodically check with their Secretary of State's office to ensure their business entity history and details remain correct. If unauthorized changes have been made, they should report them immediately.

ENLISTING EMPLOYEES' HELP

Training is important, too. A company's employees are its first line of defense against fraud perpetrators, and staff members need to know and understand their roles.

A qualified CPA can conduct training sessions on how to recognize the most common — and emerging — identity theft schemes, along with the related red flags. For example, employees should notify their managers if they discover misaddressed business mail, unexpected account statements and phone calls regarding unfamiliar accounts.

FIGHT COMPLACENCY

Business identity theft, like most kinds of fraud, thrives in environments of complacency. To avoid the potentially devastating repercussions of identity theft, your clients need to take proactive steps to combat fraudsters.

Help ensure your solvency opinion holds up in court

In a recent, influential fraudulent conveyance decision, *In re TOUSA*, the bankruptcy court ruled against the borrower, citing as a major factor an unpersuasive solvency opinion. The court faulted TOUSA's expert for, among other things, using an inappropriate industry standard, relying on stale and untested projections and preparing the solvency report in an inordinately short period of time for what looked like a contingency fee.

Don't let such mistakes trip up your clients. A qualified expert can prepare a solid solvency analysis that's more likely to sway a court.

ASSETS VS. DEBTS

A solvency opinion is an independent professional analysis that should question and test management's assumptions and projections. The need for such analysis can arise in a variety of litigation settings, including fraudulent conveyance, bankruptcy alter ego, directors and officers liability and due diligence actions.

Solvency generally is defined as a business's or individual's ability, at a specific point in time, to meet its long-term interest and repayment obligations. Both the federal Bankruptcy Code and the Uniform Fraudulent Transfer Act look at the fair value of a debtor's assets. The debtor is determined to be solvent when the fair value of assets is greater than its debts. Note, however, that a debtor may be legally solvent but nonetheless unable to pay its debts because the fair value of assets might include nonliquid assets.

3 TESTS

Solvency is characterized by positive equity (when assets exceed liabilities), the ability to pay off debts as they come due (as measured by debt-to-equity, current and quick ratios) and adequate capital to operate. With these criteria in mind, solvency analysis comprises three tests:

1. Balance sheet. This component determines whether, at the time of the transaction at issue, the debtor's asset value exceeded its liability value. The assets are valued at fair market value.

2. Cash flow. This test examines whether the debtor incurred debts that were beyond its ability to pay as they matured. It involves analysis of a series of projections of future financial performance. Such projections are developed by varying some key operating characteristics of the business, such as revenue growth.

In his or her analysis, an expert considers a range of scenarios. These include management's growth expectations, lower-than-expected growth, and no growth — as well as past performance, current economic conditions and future prospects.

3. Adequate capital. This final test determines whether a company is likely to survive in the normal course of business, bearing in mind reasonable fluctuations in the future. Relevant factors include:

- Cash flow,
- Asset values and volatility,
- The amount of debt,
- Repayment schedules, and
- Available credit.

A debtor must pass all three of the above tests to be considered solvent. In some cases, a fourth test — shareholder distribution — may be applicable.

ESSENTIAL COMPONENTS

Obtaining an accurate, authoritative solvency analysis is essential because transactions made during an insolvency period can be voided by a court. Make sure your expert has demonstrated valuation expertise and can rigorously test forward-looking financial statements.

Follow the money: How experts calculate lost earnings damages

Plaintiffs seek damages for lost earnings in cases ranging from wrongful termination to wrongful death. When calculating such damages, financial experts consider several components, including base earnings, retirement benefits and fringe benefits.

BEGIN WITH BASE EARNINGS

The initial focus in a lost earnings claim typically falls on the plaintiff's base earnings — the earnings rate for a specified year from which lost earnings will be extrapolated. Your expert will need several types of data to compute a figure for base earnings, including:

- Employer records,
- Employee pay stubs,
- Income tax records,
- Social Security records, and
- Census information or the earnings of comparable employees in the industry or company.

Information related to a plaintiff's seniority, worklife expectancy, health history and declines in productivity can provide additional insight if his or her earnings record fails to show regular annual increases.

It also may be necessary to adjust for seasonal variations and sick pay. One-off, nonrecurring payments, such as a nonperformance-based bonus or a year with unusually high earnings, can skew base earnings, as well.

REVIEW RETIREMENT PLANS

With defined contribution plans, the employer contributions are regarded as a portion of lost earnings in the years the contributions would have been made if not for the wrongful act. Instead of projecting the postretirement benefits to be paid, the expert calculates the sum of the employer contributions that would have been made.

When dealing with defined benefit plans, the expert may need to project the actual benefit stream following the plaintiff's retirement. If the benefit depends on the worker's earnings, the size of the loss will depend on the plan's details, along with the plaintiff's years of service, salary levels, expected retirement date and life expectancy.

FIGURE OUT FRINGE BENEFITS

To determine compensation for fringe benefits, experts compare the benefits received before the alleged wrongful act to those received after, possibly taking into account the replacement cost of the lost benefits. (For example, individual insurance premiums usually are higher than those paid under a group plan.) Experts distinguish between benefits that depend on the recipient's level of income and those that depend merely on being employed. Those that are triggered only by death or disability are removed from consideration.

Benefits to which both the employer and the employee contribute are closely examined. Because an employee's contribution is deducted from lost wages, he or she would be doubly compensated if damages were paid for both the contribution and lost wages. Double-dipping also can happen if vacation and sick pay are included in cash earnings, or if fringe benefits such as health insurance are included in lost earnings when the plaintiff is also seeking compensation for specific losses, such as medical bills.

The initial focus in a lost earnings claim typically falls on the plaintiff's base earnings.

DISPEL DISPUTES

Lost earnings claims often involve contentious issues, such as the effect of variable compensation like commissions, overtime and performance bonuses. The proper loss period and discount rate also may be subject to dispute. Unemployment trends merit consideration, too. For example, how certain is it that the plaintiff would have maintained uninterrupted employment?

The plaintiff's duty to mitigate the damages can raise additional questions. Defendants might argue that the plaintiff took an unreasonable period of time to find a new job or accepted a position at an unreasonably low pay rate. A vocational or employability expert can prove useful when making mitigation arguments.

THE BOTTOM LINE

Lost earnings claims often require far-reaching, complicated calculations. Attorneys should consult with their financial experts early in the process to ensure critical data is available to develop appropriate arguments.

The experience you need. The service you want.

Whether you are dealing with matters of contract disputes, fraud investigations or other economic damages, you need accountants who have extensive experience in preparing and presenting complex commercial cases. In other words, you need Arnie & Company.

For more than a decade, our firm has provided the legal community, business owners and other individuals throughout Texas with prompt, accurate and effective accounting, consulting and litigation support services that include:

- Contract dispute and analysis
- Fraud investigations
- Lost profit analysis
- Securities claims
- Shareholder derivative actions
- Purchase/Sales agreement warranty claims
- Legal and accounting malpractice claims
- Intellectual property analysis
- Other economic damage claims

Arnie & Company has an especially strong depth of experience in the analysis of commercial damages and in conducting forensic investigations. Dennis Arnie is both a Certified Public Accountant and a Certified Fraud Examiner. He has frequently testified as an expert witness in a variety of state and federal courts and various arbitration hearings.

Thanks to the firm's commitment to delivering outstanding service, Arnie & Company has become a trusted advisor to many leading law firms and businesses in the Houston, Dallas, and Austin areas. Our clients include numerous Fortune 500 companies in various industries, as well as significant privately held companies and individuals.

We welcome the opportunity to put our experience and advanced knowledge of commercial damage analysis and forensic accounting to work for you and your clients. Please call us at 713-840-1634 and let us know how we can be of assistance.

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